



2007

## Taxation

Cynthia M. Ohlenforst

Jeff W. Dorrill

Sam Megally

Steven E. Bartz

Follow this and additional works at: <https://scholar.smu.edu/smulr>

---

### Recommended Citation

Cynthia M. Ohlenforst, et al., *Taxation*, 60 SMU L. Rev. 1311 (2007)  
<https://scholar.smu.edu/smulr/vol60/iss3/26>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

# TAXATION

*Cynthia M. Ohlenforst\**

*Jeff W. Dorrill\*\**

*Sam Megally\*\*\**

*Steven E. Bartz\*\*\*\**

IN 2006, Texas legislators enacted the most substantial franchise tax reform the state has seen since 1907, coupled with major changes to the property tax mechanism for funding public schools. Given the significance of these legislative changes, this year's Survey focuses on legislative and judicial developments to the exclusion of regulatory and administrative interpretations.

## I. SALES TAX

Several cases recently decided by the Austin Court of Appeals address the scope of the Texas sales tax. *Chevron Pipe Line v. Strayhorn* upheld the application of the sales tax to otherwise nontaxable services performed in conjunction with a taxable service,<sup>1</sup> and *DuPont Photomasks v. Strayhorn* narrowly interpreted the sale-for-resale exemption.<sup>2</sup> In these decisions, the court of appeals also endorsed the Comptroller's ability to interpret the law. While the court of appeals broadly applied the sales tax, it viewed a taxpayer's means of seeking a refund much more narrowly in *Rahmes v. Louis Shanks of Texas, Inc.*, concluding that the only avenue for the taxpayers in that case to seek a refund of erroneously collected taxes was the specific statutory framework set forth in Chapters 111 and 112 of the Tax Code.<sup>3</sup>

In *Chevron Pipe Line*, the court of appeals upheld the Comptroller's determination of tax liability for excavation and backfilling services performed in conjunction with the remedial installation of cathodic pipeline protection devices, reasoning that those services were not nontaxable

---

\* B.A., Loyola University; M.A., University of Dallas; J.D., Southern Methodist University. Partner, Hughes & Luce, LLP, Dallas, Texas.

\*\* B.B.A., J.D., Baylor University. Partner, Hughes & Luce, LLP, Dallas, Texas.

\*\*\* B.B.A., Southern Methodist University; J.D., The University of Texas School of Law. Associate, Hughes & Luce, LLP, Dallas, Texas.

\*\*\*\* A.B., Duke University; J.D., Vanderbilt University Law School. Associate, Hughes & Luce, LLP, Dallas, Texas.

1. *Chevron Pipe Line Co. v. Strayhorn*, 212 S.W.3d 779, 788 (Tex. App.—Austin 2006, pet. filed).

2. *DuPont Photomasks, Inc. v. Strayhorn*, 219 S.W.3d 414, 416 (Tex. App.—Austin 2006, pet. denied).

3. No. 03-04-00298-CV, 2005 WL 3331620, \*1 (Tex. App.—Austin Dec. 9, 2005, no pet.) (mem. op. not designated for publication).

"unrelated services" under Comptroller Rule 3.357.<sup>4</sup> Chevron Pipeline Company ("Chevron") had determined that it needed to "recoat" a buried pipeline and install new cathodic protection devices.<sup>5</sup> Chevron's expert witness testified that the recoating process required several distinct crews: one crew to excavate the pipe, a second crew to strip the old coating from the pipe, a third crew to apply a new coating, and the original crew to re-cover, or "backfill," the pipeline.<sup>6</sup> Cathodic protection is, according to expert witness testimony, "a method of protecting the pipelines by installing an anode, which serves as the object of corrosion instead of the pipeline."<sup>7</sup> The method of cathodic protection that Chevron employed with regard to the pipeline in question involved running a cable from the anode bed, a separate bed away from the pipeline, to a rectifier, and then from the rectifier to the pipeline.<sup>8</sup> Third-party contractors hired by Chevron performed the installations of cathodic protection devices and the excavation and backfilling services.<sup>9</sup>

During an audit of Chevron, the Comptroller assessed taxes against Chevron for unpaid sales tax on the excavation and backfilling services it purchased.<sup>10</sup> Chevron paid the deficiency under protest and filed suit seeking a refund, arguing that the excavation and backfilling services constituted nontaxable "unrelated services."<sup>11</sup> The trial court found that the cathodic protection installations essentially repaired or upgraded the existing nonresidential real property and that the excavation and backfilling did not constitute unrelated services.<sup>12</sup> On appeal, Chevron contended, first, that the installation of cathodic protection devices was nontaxable new construction and, second, that the "excavation and backfilling services purchased in conjunction with other repair services [were] nontaxable 'unrelated services' within the meaning of Comptroller Rule 3.357."<sup>13</sup>

The court of appeals upheld the trial court's decision with respect to both issues.<sup>14</sup> In arriving at this holding, the court of appeals deferred to the Comptroller's construction of Rule 3.357, declaring that "the Comptroller has exclusive jurisdiction to interpret whether a particular service falls within the categories of 'taxable services' enumerated in section 151.0101(a) of the Tax Code."<sup>15</sup> To qualify as new construction under Rule 3.357, the activity must result in "the addition of new, usable square

---

4. *Chevron*, 212 S.W.3d at 781, 788 (discussing 34 TEX. ADMIN. CODE § 3.357 (2006) (Comptroller of Public Accounts, Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)).

5. *Id.* at 781.

6. *See id.* at 781-82.

7. *Id.* at 782.

8. *Id.*

9. *Id.*

10. *Id.* at 781.

11. *Id.* at 783.

12. *Id.*

13. *Id.* at 784 (discussing 34 TEX. ADMIN. CODE § 3.357 (2006)).

14. *Id.* at 788.

15. *Id.* at 786.

footage to an existing structure.”<sup>16</sup> Despite the fact that Chevron installed the remedial cathodic protection devices in new holes or trenches, the court of appeals held that “this activity does not meet the definition of ‘new construction’ in Rule 3.357.”<sup>17</sup> According to the court of appeals, “the evidence demonstrates that remedial installation of cathodic protection devices simply prevents the existing pipeline from corroding,”<sup>18</sup> and those devices “do not add ‘new, usable square footage to an existing structure’ within the meaning of Rule 3.357 and, therefore, do not satisfy the rule’s definition of ‘new construction.’”<sup>19</sup> To buttress this determination, Justice Patterson added the following insightful (and colorful) analogy: “[T]he remedial installations of cathodic protection devices is like adding stadium lights to Wrigley Field. It allows you to use the existing structure for a longer period of time, but it does not increase the usable square footage of the structure.”<sup>20</sup>

With regard to whether excavation and backfilling services constituted “unrelated services” performed in conjunction with the work performed on the pipeline, the court of appeals disagreed with Chevron’s assertion that those services were provided on a stand-alone basis.<sup>21</sup> Despite the fact that excavation and backfilling services are not included in the list of taxable services in Section 151.0101 of the Tax Code, the Comptroller assessed a tax due on those excavation and backfilling services purchased by Chevron in conjunction with the pipeline taxable repair services it purchased, *i.e.*, recoating the pipeline.<sup>22</sup>

The court’s analysis reaches beyond the facts of this case because many of Texas’s taxable services are subject to a similar “unrelated service” test. Under Rule 3.357(a)( 15), a service is unrelated if:

- (A) it is not the repair, remodeling, or restoration of nonresidential real property, nor a service or labor that is taxable under any other provision of the Tax Code, Chapter 151;
- (B) it is of a type that is commonly provided on a stand-alone basis; and
- (C) the performance of the service is distinct and identifiable.<sup>23</sup>

The court of appeals held that Chevron failed the second and third prongs of the test, reasoning that, although a taxpayer might purchase excavation and backfilling services on a stand-alone basis, Chevron had purchased these services to enable its repair of the buried pipeline.<sup>24</sup> Chevron’s expert witness testified that “Chevron could not recoat its un-

---

16. 34 TEX. ADMIN. CODE § 3.357(a)( 8) (emphasis added).

17. *Chevron*, 212 S.W.3d at 786.

18. *Id.*

19. *Id.* (quoting 34 TEX. ADMIN. CODE § 3.357).

20. *Id.* at 786.

21. *Id.* at 788.

22. *Id.* at 786-87.

23. *Id.* at 787; 34 TEX. ADMIN. CODE § 3.357(a)( 15).

24. *See Chevron*, 212 S.W.3d at 787-88.

derground pipelines without excavation and backfilling.”<sup>25</sup> In some ways, this holding appears somewhat inconsistent with *Rylander v. San Antonio SMSA L.P.*, which recognizes that both taxable and nontaxable items may be part of a single transaction.<sup>26</sup> The case demonstrated the Comptroller’s view that services that are nontaxable if purchased on a stand-alone basis may become taxable services if closely and inextricably related to the purchase of taxable services.<sup>27</sup>

In *DuPont Photomasks*, the Austin Court of Appeals determined that DuPont Photomasks, Inc.’s (“DuPont”) purchase of a cleanroom was not exempt from the Texas sales tax under the sale-for-resale exemption, regardless of whether the lease of the cleanroom was incidental to the lease of the building in which it was housed.<sup>28</sup> In arriving at its decision, the court of appeals upheld the validity of Rule 3.294(k)(1).<sup>29</sup> In 1996, DuPont entered into a joint venture with three semiconductor manufacturers to create the DuPont Photomasks, Inc. Reticle Technology Center, L.L.C. (the “Center”) for the purpose of developing technologies for the fabrication of photomasks.<sup>30</sup> The agreement among the companies specified that DuPont would construct and operate a cleanroom as well as a building to house the cleanroom. Moreover, the agreement defined the “Facility” as “the development and manufacturing facility to be constructed . . . and leased by [DuPont] to the [Center] and dedicated to the [Center’s] business.”<sup>31</sup> Subsequently, DuPont constructed two buildings, each of which was dedicated to facilitating the operation of the cleanroom, and, pursuant to the agreement, DuPont leased those facilities to the Center.<sup>32</sup>

Under Section 151.005, the lease of tangible personal property is a sale that is subject to taxation.<sup>33</sup> Nevertheless, for the purpose of avoiding double taxation, the lease of tangible personal property may be exempt from taxation under the sale-for-resale exemption.<sup>34</sup> The Comptroller’s rule interpreting the resale exemption provides, in relevant part, that if a contract for a real property lease includes a lease of tangible personal property (such as furniture) as part of the agreement, no sales tax is due on the lease of the tangible personal property.<sup>35</sup>

DuPont, relying upon the fact that the items it purchased to construct the cleanroom would be leased to the Center, did not pay sales tax on the

---

25. *Id.* at 788.

26. 11 S.W.3d 484, 487 (Tex. App.—Austin 2000, no pet.); see Cynthia M. Ohlenforst et al., *Taxation*, 54 SMU L. REV. 1595, 1596-97 (2001); see also Cynthia M. Ohlenforst et al., *Taxation*, 59 SMU LAW REVIEW 1565, 1566 (2006).

27. *San Antonio SMSA*, 11 S.W.3d at 487.

28. *DuPont Photomasks*, 219 S.W.3d at 419-20.

29. *Id.* (discussing 34 TEX. ADMIN. CODE § 3.294 (2006) (Comptroller of Public Accounts, Rental of Tangible Personal Property)).

30. *Id.* at 416.

31. *Id.*

32. *Id.*

33. TEX. TAX CODE ANN. § 151.005 (Vernon Supp. 2006).

34. *DuPont Photomasks*, 219 S.W.3d at 419.

35. *Id.* (discussing 34 TEX. ADMIN. CODE § 3.294(k)(1) (2006)).

purchase of the items used to construct the cleanroom.<sup>36</sup> DuPont argued that the resale exemption applied because the purchased personal property to be leased was “of greater importance than the leasing of the real property,” reasoning that the phrase “incidental to” in Section 151.006 means “subordinate to” or “a minor accompaniment.”<sup>37</sup> According to DuPont’s reading of Section 151.006, “rule 3.294(k) improperly prohibits the invocation of the exemption for the lease of real and personal property when the lease of the personal property is of paramount importance to the agreement,” and the Comptroller exceeded her rulemaking authority by contravening the plain language of the statute.<sup>38</sup>

The court of appeals summarily dismissed DuPont’s contention that the comptroller exceeded her rulemaking authority,<sup>39</sup> noting that the court “will defer to an agency’s interpretation as long as it is reasonable and does not contradict the plain meaning of the statute.”<sup>40</sup> The court of appeals further concluded that the “plain meaning” of the phrase “incidental to” is unclear; “incidental to” may be used interchangeably with “incident to,” and these phrases may mean either “happening by chance and subordinate to some other thing; peripheral” or “closely relating to; naturally appearing with.”<sup>41</sup> Because the Comptroller’s interpretation of the resale exemption was longstanding, the court of appeals was willing to presume that the legislature had adopted the Comptroller’s construction by the legislature’s re-enactment without substantial change of the statutory provisions.<sup>42</sup> Third, the court of appeals favored the public policy implications of a bright-line rule that “tangible personal property leased in conjunction with real property is not eligible for the sale-for-resale exemption” over a subjective analysis based on the parties’ intent.<sup>43</sup>

The court of appeals further concluded that DuPont could not avail itself of the Section 151.006(2) resale exemption, which allows an exemption for the sale of tangible personal property “for the sole purpose of the purchaser’s leasing or renting *it*,” reasoning that the tangible personal property, and not the constituent parts purchased to construct or create such tangible personal property, is what must be both purchased and leased or rented.<sup>44</sup> The court of appeals noted that “DuPont did not purchase a cleanroom; on the contrary, it purchased various items that were assembled to make a cleanroom,” and that, therefore, the purchase of “the items necessary for the construction of the cleanroom” was not exempt.<sup>45</sup>

---

36. *Id.*

37. *Id.* at 420-21.

38. *Id.* at 420.

39. *Id.*

40. *Id.*

41. *Id.* at 420-21.

42. *Id.* at 422.

43. *Id.*

44. *DuPont Photomasks*, 219 S.W.3d at 423 (discussing TEX. TAX CODE ANN. § 151.006(2) (Vernon 2002) (emphasis added)).

45. *Id.*

The court of appeals also tackled the rights of taxpayers to claim refunds. *Rahmes v. Louis Shanks of Texas, Inc.* confirmed that taxpayers have no common-law right to seek refunds for erroneously collected taxes.<sup>46</sup> Todd Rahmes filed suit against Louis Shanks of Texas, Inc., a furniture store, and the Metropolitan Transit Authorities ("MTA") seeking a refund of sales tax improperly charged on a delivery of furniture beyond the MTA's jurisdictional territory.<sup>47</sup> Although Rahmes acknowledged that Chapters 111 and 112 of the Tax Code provide a comprehensive administrative scheme for taxpayers who seek a refund, Rahmes contended that the Tax Code did not provide an exclusive remedy and that he also had a "common-law right to recover taxes that were paid involuntarily under fraud, duress, or mistake."<sup>48</sup> The court of appeals disagreed and held that Chapters 111 and 112 of the Tax Code provide a taxpayer's exclusive remedy for seeking a refund.<sup>49</sup>

## II. FRANCHISE TAX

Although once imposed solely on taxable capital, the franchise tax has included an alternate "earned surplus" calculation, based loosely on federal taxable income, since a 1991 legislative expansion of the tax. Both the pre- and post-1991 tax applied to corporations, limited liability companies, and banking corporations, but until the 2006 amendments, not to partnerships, or to limited partners whose only connection with Texas is a limited partnership interest. The Texas Supreme Court's mandate that the legislature find a constitutional plan for school funding by a June 2006 deadline,<sup>50</sup> coupled with legislative frustration at the large number of entities that successfully planned around the tax by operating through partnerships, set the stage for sweeping changes to the long-standing Texas franchise tax.

The Governor appointed a special commission which held hearings across the state and ultimately presented legislators with recommendations to change fundamentally the calculation of the franchise tax. The commission's recommendations formed the basis for what became House

---

46. No. 03-04-00298-CV, 2005 WL 3331620 \*4 (Tex. App.—Austin Dec. 9, 2005, no pet.).

47. *Id.* at \*1.

48. *Louis Shanks*, No. 03-04-00298-CV, 2006 WL 3331620, at \*2.

49. *Id.* at \*5. The ability of taxpayers to request refunds directly from the state, rather than through the seller from whom the taxpayers purchased good, has varied over the past. As the court of appeals noted, in 2003, the legislature amended Section 111.104 of the Texas Tax Code and "removed a taxpayer's right to directly initiate administrative proceedings so that, as of June 20, 2003, a taxpayer must first obtain an assignment of rights before filing an administrative refund claim." *Id.* at \*4 n.7. The court of appeals did not reach Rahmes's claim that the 2003 legislative amendment is "an unconstitutional restraint on the open courts provision because it permits a retailer to 'completely control' whether a consumer may seek a remedy" because Rahmes purchased the furniture on which he paid the improperly charged sales tax in May of 2000. *Id.* at \*4 n.7; *see also id.* at \*1.

50. The Texas Supreme Court accelerated the push for tax reform by holding, in *Neeley v. W. Orange-Cove Consolidated Ind. Sch. Dist.*, 176 S.W.3d 746 (Tex. 2005) that Texas's method of funding public education violates the Texas Constitution.

Bill No. 3 and included an entirely new tax that combines elements of a gross receipts tax with elements of a net income tax. Partly because of the Texas Supreme Court's deadline and partly because of the political environment, the House quickly passed House Bill No. 3 with very few amendments. Then, although many House members undoubtedly expected to see the bill again in conference committee, the Senate passed the House version without any amendments.<sup>51</sup> An advantage of the legislature's prompt action is the timely enactment of a reformed tax; a disadvantage is the confusion that arises from some of the enacted language, including from ambiguities and drafting errors that legislators did not have the opportunity to fix before the session ended.

When this article was written, the legislature was considering technical (and perhaps other) changes to the law; both the State Bar of Texas Tax Section<sup>52</sup> and the Texas Society of Certified Public Accountants<sup>53</sup> released written comments on the tax, and the recently elected Texas Comptroller and her staff were working to provide guidance to both legislators and taxpayers.<sup>54</sup>

### Overview

The new law is effective for reports filed on or after January 1, 2008,<sup>55</sup> and, like other taxes based on activity during a period prior to the report year, the tax reaches back to 2007—and even earlier for some taxpayers.<sup>56</sup>

While the new tax incorporates many provisions from prior law, the margin tax differs from the “old” franchise tax in several material respects:

- (1) it applies to additional businesses/entities;<sup>57</sup>
- (2) it has a different starting point (revenue);<sup>58</sup>

---

51. The Senate's decision not to amend the bill reflected the court's deadline, political pressures, and the Senate's concern that the House would be unable to muster sufficient votes to pass an amended bill. Note also that House Bill No. 3 is part of the larger tax and education legislation enacted during the 2006 special session.

52. [http://www.texasbar.org/SectionofTaxationlettertoFrankBattle\\_HB3.pdf](http://www.texasbar.org/SectionofTaxationlettertoFrankBattle_HB3.pdf) [hereinafter the “Texas Tax Section Comments”].

53. <http://www.tscpa.org/gvt/News/MarginTaxReport1106.asp> [hereinafter the “TSCPA Comments”].

54. See H.B. 3 § 23, 79th Leg., 3d C.S. (Tex. 2006) (requiring the state's largest taxpayers—measured by several different reference points, including amount of 2005 report period tax liability, 2005 gross receipts, 2005 number of employees, and amount of school maintenance—and operations property tax for 2005—to file these “information reports.” Comptroller Guidelines (available at [http://www.window.state.tx.us/taxinfo/franchise105-158\\_instructions/index.html](http://www.window.state.tx.us/taxinfo/franchise105-158_instructions/index.html)) for filing the returns were among the first interpretations of the new tax).

55. H.J. of Tex., 79th Leg., 3d C.S. 140-42 (2006).

56. H.B. 3 § 22, 79th Leg., 3d C.S. (Tex. 2006).

57. See TEX. TAX CODE ANN. § 171.0002(a) (Vernon Supp. 2006) (as effective January 1, 2008) (all subsequent references to the Texas Tax Code are to this January 1, 2008 version of the Code unless otherwise noted).

58. See TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon Supp. 2006).



- (3) it requires combined reporting for many entities;<sup>59</sup>
- (4) it has different rates for different taxpayers (one percent for most taxpayers and one half percent for wholesale and retail sellers);<sup>60</sup> and
- (5) it allows deductions from revenue for either (a) cost of goods sold or (b) compensation,<sup>61</sup> in both cases, as defined by the Texas Tax Code and as apportioned to Texas.<sup>62</sup>

Generally, the starting point for computing the margin tax is a taxable entity's total revenues.<sup>63</sup> A taxable entity subtracts from this "revenue" number its choice of either cost of goods sold ("COGS") or compensation.<sup>64</sup> This election may be changed on an annual basis<sup>65</sup> and applies to all members of a combined reporting group,<sup>66</sup> each of which computes its revenue and deductions separately.<sup>67</sup> The resulting amount is the entity's margin.<sup>68</sup> The margin is multiplied by the entity's Texas apportionment factor,<sup>69</sup> which is the entity's Texas gross receipts divided by its total gross receipts.<sup>70</sup> Thus, the single-factor formula used for the old franchise tax<sup>71</sup> is generally retained but without the throwback rule.<sup>72</sup> The resulting amount is the entity's taxable margin.<sup>73</sup> The taxable margin is then multiplied by the one-percent tax rate (or the one-half percent tax rate for retailers and wholesalers),<sup>74</sup> to arrive at the entity's tax.<sup>75</sup> Taxpayers with total revenue of less than or equal to \$300,000 (with CPI adjustments for later years) or total tax liability of less than \$1,000 are not required to pay the tax.<sup>76</sup> Additionally, the tax may be reduced by certain already accrued but unused credits,<sup>77</sup> as well as by a credit for certain losses.<sup>78</sup>

### *Entities That Are Subject to Margin Tax*

Although many proponents of the new tax describe the tax as applicable to all entities that have limited liability under state law, the list of taxable entities is more specific than, and sometimes inconsistent with,

---

59. See TEX. TAX CODE ANN. § 171.1014 (Vernon Supp. 2006).

60. See TEX. TAX CODE ANN. § 171.002(a), (b) (Vernon Supp. 2006).

61. See TEX. TAX CODE ANN. § 171.101(a)(1)(B)(ii) (Vernon Supp. 2006).

62. TEX. TAX CODE ANN. § 171.106 (Vernon Supp. 2006).

63. TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon Supp. 2006).

64. § 171.101(a)(1)(B)(ii).

65. § 171.101(d).

66. TEX. TAX CODE ANN. § 171.1014(d) (Vernon Supp. 2006).

67. § 171.1014(c), (e), (f).

68. TEX. TAX CODE ANN. § 171.101(a) (Vernon Supp. 2006).

69. § 171.101(a)(2).

70. TEX. TAX CODE ANN. § 171.106(a) (Vernon Supp. 2006).

71. TEX. TAX CODE ANN. § 171.106(a) (Vernon 2002) (as in effect until January 1, 2008).

72. TEX. TAX CODE ANN. § 171.103(1) (Vernon 2002) (as in effect until January 1, 2008). Texas held the throwback rule unconstitutional, at least on facts presented, in *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856 (Tex. App.—Austin 2005, pet. denied).

73. TEX. TAX CODE ANN. § 171.101(a) (Vernon Supp. 2006).

74. TEX. TAX CODE ANN. § 171.002(a), (b) (Vernon Supp. 2006).

75. § 171.002(b).

76. § 171.002(d).

77. See H.B. 4 §§ 17-19, 79th Leg., 3d C.S. (Tex. 2006).

78. TEX. TAX CODE ANN. § 171.111 (Vernon Supp. 2006).

that description.<sup>79</sup> A significant change to the tax is its application for the first time to partnerships.<sup>80</sup> Although not all partnerships are subject to the tax, the legislature—after many unsuccessful efforts during prior sessions—successfully extended the tax to most limited partnerships.<sup>81</sup> Because operating in partnership form has been a key component of Texas franchise tax planning for years, expanding the tax to partnerships is expected to bring large numbers of taxpayers into the tax net. The net is made even broader by the adoption of combined reporting, discussed below.

The margin tax provides that the “taxable entities” subject to the tax include all legal entities (including limited partnerships, which were not taxable under the old franchise tax) other than those set forth in an enumerated list that includes the following:

- Sole proprietorships;<sup>82</sup>
- General partnerships, the direct ownership of which is composed exclusively of natural persons;<sup>83</sup>
- “Passive entities;”<sup>84</sup>
- Certain entities, such as some nonprofits, that were exempt under the old franchise tax are still exempt under the new margin tax;<sup>85</sup>
- Grantor trusts with natural persons or charitable entities as the sole beneficiaries;<sup>86</sup>
- Estates of natural persons;<sup>87</sup>
- Escrows;<sup>88</sup>
- Family partnerships that are passive entities;<sup>89</sup>
- “Passive investment partnerships;”<sup>90</sup>
- Certain passive entities—trusts with natural persons or charitable entities as their sole beneficiaries;<sup>91</sup>
- Real Estate Investment Trusts (“REITs”) that do not directly own real property (other than the real estate that the REIT occupies “for business purposes”) and qualified REIT subsidiaries;<sup>92</sup> and
- Investment conduits.<sup>93</sup>

The new tax includes several “cliffs” that trigger all-or-nothing results: one step over the cliff (e.g., one non-qualifying partner) and disaster may

---

79. TEX. TAX CODE ANN. § 171.0002 (Vernon Supp. 2006).

80. § 171.0002(a).

81. *Id.*

82. § 171.0002(b)(1).

83. § 171.0002(b).

84. TEX. TAX CODE ANN. § 171.0002(b)(3) (Vernon Supp. 2006).

85. § 171.0002(b)(4).

86. § 171.0002(c)(1).

87. § 171.0002(c)(2).

88. § 171.0002(c)(3).

89. TEX. TAX CODE ANN. § 171.0002(c)(4) (Vernon Supp. 2006).

90. § 171.0002(c)(5).

91. § 171.0002(c)(7).

92. § 171.0002(c)(8).

93. § 171.0002(c)(9); § 171.0002(d).

ensue (e.g., a nontaxable general partnership becomes taxable). For example, if a partner dies and the partner's estate holds the partnership interest, the otherwise nontaxable general partnership no longer qualifies as nontaxable—it now has a partner that is not a “natural person.” However, it is widely believed that legislators did not anticipate or intend that a partner's death would transform a nontaxable partnership into a taxable one, and legislators appear ready to change the statute to avoid the harsh, unintended consequences that might otherwise result from this “cliff” language.<sup>94</sup> The grantor trust provision appears to create another cliff, so that when a beneficiary dies or a charitable entity beneficiary ceases to qualify as a charitable entity, the trust would become taxable.

Although many legislators believed they had enacted a tax that reached lawyers and accountants practicing in limited liability partnerships, a drafting error appears to allow such LLPs a technical escape route if all partners are natural persons: Texas LLPs are general partnerships that elect LLP status,<sup>95</sup> so LLPs composed entirely of natural persons should not be subject to the tax. However, even before the last special session ended, legislators were focusing on changes to ensure that the tax applies to LLPs, which are among the entities targeted by many legislators.

Legislators intend that nonprofit entities of the type that are exempt from the old franchise tax also be exempt from the margin tax. Accordingly, a new Tax Code section provides an exemption for a noncorporate entity that would qualify for one of the specific exemptions if it were a corporation.<sup>96</sup> Although legislative intent is relatively clear—to continue to provide an exemption for the type of entities that Texas has previously exempted—the language is somewhat imprecise. For example, because trusts are not subject to the pre-margin franchise tax, the pre-margin franchise tax statute does not include an exemption for trusts, or a specific reference to tax-exempt trust-retirement plans. A technical correction is likely to include a specific exemption for qualified pension, profit sharing, and stock bonus plans, as defined in the Internal Revenue Code.

In many respects, real estate businesses fare relatively well under the new tax, although unanswered questions remain concerning both computation and application of the tax to real estate enterprises. Although REITs may be nontaxable, REIT partnership subsidiaries may be taxable, so many real estate investments appear more likely to be taxed, even if indirectly, than under prior law.

Determining the standards for which holdings are “direct” holdings, and when real estate is used “for business purposes” will likely trigger continued controversy.

---

94. All this talk of cliffs and falling should not discourage the wary from thoughtful analysis and perhaps even creative planning.

95. See TEX. BUS. ORG. CODE ANN. §§ 152.802-.804 (Vernon Supp. 2006).

96. § 171.088.

*Federal Tax Classification*

Texas has not traditionally followed federal tax classifications although the earned surplus calculation of the pre-margin franchise tax is computed by reference to federal tax numbers. Nor does the margin tax consistently follow federal income tax classifications, but it is computed by reference to federal tax revenue. Significantly, limited liability companies that are disregarded and treated as sole proprietorships for federal income tax purposes are not treated as exempt sole proprietorships for margin tax purposes.

To the extent the old franchise tax relied on the federal Internal Revenue Code and Treasury regulations, it referred to the code and regulations as in effect for the federal tax years beginning before January 1, 1997, prior to the effective date of the federal “check-the-box” entity classification rules.<sup>97</sup> The margin tax, by contrast, refers to the Internal Revenue Code and Treasury Regulations in effect for the federal tax year beginning on January 1, 2006—well after the effective date of the check-the-box regulations and other federal law regarding disregarded entity principles.<sup>98</sup>

*Special Rules For Passive Entities*

A limited exclusion from the tax exists for certain trusts and partnerships that meet the definition of passive entities.<sup>99</sup> The distinction between the taxability of partnerships and that of corporations remains in this context and may merit a continued preference for partnerships in some situations.

A “passive entity,” which is excluded from the definition of “taxable entity,” is defined as a partnership or trust: (1) with over ninety percent of its federal gross income from:<sup>100</sup> “dividends, interest, foreign-currency-exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company”;<sup>101</sup> positive distributive shares of partnership income;<sup>102</sup> “gains from the sale of real property, commodities traded on a

---

97. TEX. TAX CODE ANN. § 171.001 (Vernon 2002) (as in effect until January 1, 2008) (“Internal Revenue Code” (“I.R.C.”) means the Internal Revenue Code of 1986 in effect for the federal tax year beginning on or after January 1, 1996, and before January 1, 1997, and any regulations adopted under that code applicable to that period.).

98. Another effect of updating the I.R.C. reference is that the depreciation rules under the margin tax now match current federal law. Questions remain about how taxpayers should reflect the transition from the old I.R.C. depreciation to computing depreciation under the current I.R.C. for their COGS calculations. This updating for margin tax purposes of the reference to the I.R.C. may create some confusion as to when and how federal disregarded entity principles affect margin tax computations.

99. TEX. TAX CODE ANN. § 171.0002(b)(3) (Vernon Supp. 2006).

100. TEX. TAX CODE ANN. § 171.0003(a)(2) (Vernon Supp. 2006).

101. § 171.0003(a)(2)(A).

102. § 171.0003(a)(2)(B).

commodities exchange, and securities";<sup>103</sup> and royalties, bonuses, or delay rental income from mineral properties and income from other mineral interests not operated directly or by an affiliate (rent is specifically excluded from passive sources);<sup>104</sup> and (2) with not more than ten percent of its federal gross income from an active trade or business,<sup>105</sup> where (i) items of income in (1) are not from an active trade or business,<sup>106</sup> (ii) "active trade or business" is defined in very general terms,<sup>107</sup> and (iii) income from licensing intangibles to affiliates for use in their active trade or business is deemed active to the licensor.<sup>108</sup>

It appears unclear whether a taxable entity could ever pass the ninety-percent-passive test but fail the ten-percent-active test. The overlapping definitions apparently resulted from combining multiple draft provisions without the time or redrafting that typically accompanies major tax legislation; ideally, the technical corrections bill should repeal the confusing ten-percent test. Another issue legislators will address is whether the "gains" from the sale of real property included in the ninety-percent computation refer only to federal income tax *capital* gains or to *all* gains from the sale of property, regardless of federal characterization.

A "passive entity" is by definition not subject to the tax. Confusingly, the margin-tax statute lists four categories of specific "passive entities" that are excluded from the definition of taxable entity if they meet other, additional criteria.<sup>109</sup> Given the fact that an entity which meets the "passive entity" definition appears to be nontaxable without regard to any of the other requirements established for the additional categories, the significance of these additional requirements is debatable. Administrative guidelines and rules could take the position that these "extra" requirements must be met, although such a result would appear contrary to legislative intent. As with respect to the ninety-percent-active and ten-percent-passive income tests, the additional tests appear to be the result of cobbling together various draft legislative proposals rather than a plan to create a two-prong test, and the legislature is likely to reconsider the additional tests.

---

103. § 171.0003(a)(2)(C).

104. § 171.0003(a)(2)(D); (b)(1)-(b)(2). The exclusion of rent from amounts that count toward the ninety-percent gross income test is clearly a key factor for real estate businesses.

105. TEX. TAX CODE ANN. § 171.0003(a)(3) (Vernon Supp. 2006).

106. § 171.0003(a-1).

107. TEX. TAX CODE ANN. § 171.0004(b) (Vernon Supp. 2006).

108. § 171.0004(d). Although some commentators refer to passive entities as "exempt," it is more accurate to treat them as being excluded from the tax base, rather than being subject to the stricter burden of proof that applies to exemptions.

109. See TEX. TAX CODE ANN. §§ 171.0002(c)(4) (Vernon Supp. 2006) (family limited partnership); (c)(5) (passive investment partnership); (c)(6) (passive investment general partnership); and (c)(7) (trust passive entity).

### *Revenues: The Starting Point for Calculating Margin Tax*

Although the margin tax is not a straight gross receipts tax, the computation begins with a number that approximates gross receipts for many companies. In an effort to tie at least some of the margin calculations to taxpayers' federal tax returns, legislators tied the starting point for most taxpayers to taxpayers' federal tax return numbers. The statute specifies two sets of federal tax return line items includible in revenue, one set for an entity "treated for federal income tax purposes as a corporation"<sup>110</sup> and another set for an entity "treated for federal income tax purposes as a partnership."<sup>111</sup> Revenues begin with this number, from which certain specified items are subtracted.<sup>112</sup> For other taxable entities, the statute directs the Comptroller to adopt rules for computing margin "in a manner substantially equivalent" to the above definitions.<sup>113</sup>

The specified line items of federal income generally include items of gross income before deductions or offsets. But, as a result of what has been widely characterized as a drafting error, only *net* income from partnership real property rental activities is included in the margin tax calculation.<sup>114</sup> Legislators have already indicated that the provision should be revised to include gross rents.<sup>115</sup> Also, guaranteed payments are double counted in the tax base as a result of another drafting error,<sup>116</sup> and legislators appear poised to correct this error as well.<sup>117</sup>

### *Subtractions from Revenue*

A taxable entity may exclude or subtract, to the extent otherwise included in total revenues, certain specified items set forth in an enumerated list that includes the following:<sup>118</sup>

- Bad debt if expensed for federal tax purposes;<sup>119</sup>
- Distributive shares of income from pass-through entities, Schedule C deductions, and "items of income attributable to" disregarded entities (in all cases, other than any income from "passive entities");<sup>120</sup>

110. TEX. TAX CODE ANN. § 171.1011(c)(1)(A) (Vernon Supp. 2006) (revenue computed by adding IRS Form 1120, line 1c, to Form 1120, lines 4 through 10).

111. § 171.1011(c)(2)(A) (revenue computed by adding IRS Form 1065, line 1c, to Form 1065, lines 4 through 7, and Form 1065, Schedule K, lines 2 through 11).

112. § 171.1011(c)(1)(B); (c)(2)(B).

113. § 171.1011(c)(3).

114. § 171.1011(c)(2)(A)(iii) (adding line 2 of Internal Revenue Service Form 1065, Schedule K, which references *net* rental real estate income).

115. Tex. H.R. Cong. Res. 51, 79th Leg., 3d C.S., 2006 Tex. Gen. Laws 1 (taxes affecting businesses) (evidencing legislative intent to make this revision).

116. TEX. TAX CODE ANN. § 171.1011(c)(2)(A) (Vernon Supp. 2006).

117. Tex. H.R. Cong. Res. 51, 79th Leg., 3d C.S., 2006 Tex. Gen. Laws 1 (taxes affecting businesses) (evidencing legislative intent to make this revision).

118. § 171.1011(c)(1)(B), (c)(2)(B), (f), (g), (g-1), (g-2), (g-3), (k), (m), (m-1), (n), (o), (q), (r).

119. § 171.1011(c)(1)(B)(i), (c)(2)(B)(i).

120. § 171.1011(c)(1)(B)(iii), (c)(1)(B)(v), (c)(2)(B)(iii), (c)(2)(B)(iv). These subtractions generally are aimed at ensuring that taxable margin is taxed only at one level.

- “Flow-through” items that must be paid to other entities, including taxes collected and remitted; sales commissions to non-employees for real estate sales and “sales of products”; the tax basis of underwritten securities; and payments to subcontractors for real property surveying, repair, or improvements;<sup>121</sup>
- Dividends and interest from federal obligations, including foreign royalties and dividends, such as amounts determined under section 78 or sections 951-964 of the Internal Revenue Code;<sup>122</sup>
- Principal repayments received by lending institutions;<sup>123</sup>
- The federal tax basis of securities and loans sold;<sup>124</sup>
- For lawyers, certain trust fund items and pro bono expenses;<sup>125</sup>
- Reimbursements received by a “management company” for specified costs, including labor costs;<sup>126</sup>
- Certain types of elderly, indigent health care, and worker’s compensation governmental reimbursements and costs of uncompensated care; and<sup>127</sup>
- Revenue from small-production oil and gas wells during periods of low prices,<sup>128</sup> as certified by the Comptroller.<sup>129</sup>

---

121. TEX. TAX CODE ANN. § 171.1011(g)(3) (Vernon Supp. 2006). Legislators intend that certain flow-through items should be excluded from the tax base, although the scope of flow-through expenses remains the subject of debate. To the extent flow-through items are not included in revenue in the first place, no deduction is necessary to exclude the items from the tax base. Thus, taxpayers should consider carefully whether or when payments that are not taxable income can appropriately be excluded from revenue reported on the federal tax returns.

122. § 171.1011(m).

123. § 171.1011(g-1).

124. § 171.1011(g-2). Gains from the sale of securities are passive income for purposes of the seller’s qualification as a nontaxable passive entity. The statute includes no definition of securities for purposes of the passive-income test, and several commentators have suggested that the legislature should enact a statutory definition. TEX. TAX CODE ANN. § 171.0003(a)(2)(C) (Vernon Supp. 2006); *see, e.g.*, Tax Section of the State Bar of Texas State and Local Tax Committee Draft Comments to House Bill 3, p.10. Texas Society of Certified Public Accountants Comments to House Bill 3, p.11.

125. § 171.1011(g-3). The pro bono exclusion from revenue for lawyers is limited to \$500 “per case” and excludes only “actual out-of-pocket expenses.” *Id.*

126. TEX. TAX CODE ANN. § 171.1011(m-1) (Vernon Supp. 2006). These costs are also treated as part of the managed company’s compensation or COGS deduction. “Management company” is defined as “a corporation, limited liability company, or other limited liability entity that conducts all or part of the active trade or business of another entity” in exchange for a management fee and reimbursement of specified costs. The statute does not define what, in this context, constitutes conducting part of the active business, what items qualify for reimbursement, or how allocated expenses are treated.

127. In contrast to the fifty-percent deduction for costs of uncompensated care that is allowed for health care institutions, physicians may deduct one hundred percent of specified health care costs. Unlike the pro bono exclusion for attorney, the exclusion for uncompensated health care is not subject to a dollar limit and excludes the “actual cost to the health care provider for any uncompensated care provided.” TEX. TAX CODE ANN. § 171.1011(n)(2) (Vernon Supp. 2006). It was widely expected that the deductions available to physicians would be larger, based on discussions among physician groups and legislators; it is unclear whether the current legislative session will bring further changes. TEX. TAX CODE ANN. § 171.1011(o) (Vernon Supp. 2006).

128. § 171.1011(r).

129. § 171.1011(s).

*Deductions From Revenues to Determine the "Margin"*

A taxable entity computes its "margin" by subtracting, from total revenues, its unilateral choice of either "cost of goods sold" ("COGS") or "compensation,"<sup>130</sup> although the taxable margin is capped at seventy percent of total revenue from the entire business.<sup>131</sup> However, entities required to file as a combined group will make an election that applies to all the members;<sup>132</sup> thus, as a practical matter, separate companies in a combined group are not permitted to choose which deduction to use. Moreover, service companies effectively have no choice because the COGS deduction is available only to sellers of goods.<sup>133</sup> Taxpayers may change the election to deduct either COGS or compensation annually, and the statute explicitly provides that the election may be changed after the fact for a given year by filing an amended return.<sup>134</sup>

Legislators will undoubtedly be urged to modify these provisions to avoid the potential inequity underlying a tax plan that can so severely penalize companies for being part of a combined group, but it is unclear whether the cost of changing the tax (or the perceived risk of abusive taxpayer planning) will preclude substantive legislative amendments.

*The COGS Deduction*

Rather than directly incorporating federal tax or generally accepted accounting principle computations, the new Texas law defines COGS at length.<sup>135</sup> The statute defines "Goods" to mean "real or tangible personal property sold in the ordinary course of business of a taxable entity."<sup>136</sup> Thus, as noted earlier, an entity that does not sell goods effectively has no choice of deduction.<sup>137</sup> Instead, the entity is limited to the compensation deduction. Although federal income tax law addresses costs of goods sold, and Forms 1120 and 1065 both include such costs, the Texas definition does not match the federal concept.<sup>138</sup> Nonetheless, several federal tax rules and authorities are relevant.<sup>139</sup>

COGS includes only costs associated with real or tangible personal property (such as software and certain films, recordings, and books),<sup>140</sup> and the statute explicitly provides that tangible personal property does

---

130. TEX. TAX CODE ANN. § 171.101(a)(1)(B)(ii) (Vernon Supp. 2006).

131. § 171.101(a)(1)(A).

132. TEX. TAX CODE ANN. § 171.1014(d) (Vernon Supp. 2006).

133. See TEX. TAX CODE ANN. § 171.1012(a) (Vernon Supp. 2006).

134. TEX. TAX CODE ANN. § 171.101(d) (Vernon Supp. 2006).

135. TEX. TAX CODE ANN. § 171.1012.

136. § 171.1012(a)(1).

137. § 171.1012(k).

138. See Line 2 on both returns.

139. See, e.g., I.R.C. §§ 263A (2005) (capitalization and inclusion in inventory costs of certain expenses); I.R.C. § 460 (1997) (special rules for long-term contracts); I.R.C. § 471 (1997) (inventories), each of which is cross-referenced by TEX. TAX CODE ANN. § 171.1012(g) (Vernon Supp. 2006).

140. See, e.g., § 171.1012(a)(3)(A)(ii).



not include sales of services or intangible property.<sup>141</sup> This definition of tangible personal property, unlike the sales tax statutory definition, does not specifically reference computer programs or telephone prepaid calling cards.<sup>142</sup> However, subsequent margin tax subsections add specific references to films, sound recordings, and "other similar property."<sup>143</sup> The margin tax also adopts the sales tax definition of "computer program."<sup>144</sup> Many aspects of the COGS definition turn on whether a particular cost is a "direct" cost of producing or acquiring goods,<sup>145</sup> but the statute does not explicitly provide a global standard for differentiating "direct" and "indirect" costs, or indicate whether interpretations developed for other Texas tax purposes apply (e.g., in the context of the sales tax manufacturing exemption).<sup>146</sup> "Production" is defined to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising or growth."<sup>147</sup> Some sections of this laundry list, but not all, refer to both production and acquisition,<sup>148</sup> although it appears that many of the inconsistent provisions are drafting omissions rather than intended distinctions.

*Items included in COGS*

COGS explicitly includes all "direct" costs of producing or acquiring goods, including the following:<sup>149</sup>

- Labor;<sup>150</sup>
- Integrated materials;<sup>151</sup>
- Materials consumed in production processes;<sup>152</sup>

---

141. § 171.1012(a)(3)(B). The definition of tangible personal property appears to have roots in both federal tax principles and Texas sales tax. *See* TEX. TAX CODE ANN. § 151.009 (Vernon 2002) ("tangible personal property" for sales tax purposes).

142. *Compare* § 171.1012(a)(3)(A), with § 151.009.

143. *See, e.g.*, § 171.1012(a)(3)(A)(ii).

144. TEX. TAX CODE ANN. § 171.1012(a)(3)(A)(iii) (Vernon Supp. 2006).

145. *See* § 171.1012(c).

146. *See, e.g.*, TEX. TAX CODE ANN. § 151.318(a)(2) (Vernon Supp. 2006) (manufacturing exemption reference to "tangible personal property directly used or consumed in" manufacturing).

147. TEX. TAX CODE ANN. § 171.1012(a)(2) (Vernon Supp. 2006).

148. *See, e.g.*, § 171.1012(f).

149. § 171.1012(c).

150. § 171.1012(c)(1). While labor cost appears to include wages and benefits, questions exist concerning the employer's share of payroll expenses. The inclusion of labor in the COGS deduction means that sellers of goods electing a COGS rather than a compensation deduction are effectively entitled to a deduction for at least some compensation costs. Moreover, the COGS deduction appears to include some labor costs that are excluded from the compensation deduction, such as amounts paid to independent contractors, or salary and wage amounts in excess of \$300,000 per person per year.

151. § 171.1012(c)(2). The statute also allows a deduction for integrated materials and refers to materials that are an "integral part" of specific property produced; however, the statute does not explicitly specify whether the integral-part standard is to be determined by reference to existing state law interpretations from other contexts (e.g., from sales tax construction concepts).

152. TEX. TAX CODE ANN. § 171.1012(c)(3) (Vernon Supp. 2006). This deduction for materials consumed in production raises still more definitional issues ("consumed in" and "production") with respect to which sales tax concepts may be useful. *See, e.g.*, TEX. TAX CODE ANN. § 151.318 (Vernon 2002) (manufacturing exemption).

- Packaging and handling and inbound transportation costs;<sup>153</sup>
- Storage costs;<sup>154</sup>
- “Depreciation, depletion, and amortization, to the extent associated with and necessary for the production of goods”<sup>155</sup>
- Costs to rent or lease equipment, facilities, and real property directly used for production, including pollution control equipment and intangible drilling and dry hole costs;<sup>156</sup>
- Costs of preparing and maintaining production equipment and facilities, including pollution control equipment;<sup>157</sup>
- Costs attributable to research, experimental, engineering, and design activities directly related to the production of goods, including Internal Revenue Code Section 174 research and development expenditures;<sup>158</sup>
- Geological and geophysical costs incurred to locate property with “the potential to produce minerals”;<sup>159</sup>
- Certain taxes related to direct production costs;<sup>160</sup>
- Cost of producing or acquiring electricity for sale; and<sup>161</sup>
- Contributions to a partnership in which the taxable entity owns an interest that is used to fund activities, the cost of which would otherwise be treated as the partnership’s COGS (but only to the extent the costs are “related to” goods distributed to the taxable entity as goods in kind in the ordinary course of production activities).<sup>162</sup>

While the statutory subsection containing the list above addresses “direct costs,”<sup>163</sup> a subsequent subsection provides that COGS also includes the following “in relation to the taxable entity’s goods.”<sup>164</sup> Again, the cobbling together of various drafts appears to have resulted in two separate lists where, given the luxury of more time, the legislators might have

---

153. § 171.1012(c)( 4).

154. § 171.1012(c)( 5).

155. § 171.1012(c)( 6). The deductible amounts of depreciation, depletion, and amortization generally are determined with respect to federal income tax principles, but no explicit guidance is provided to determine whether a particular amount is “associated with and necessary for the production of goods.” This provision is one of many that mixes federal tax concepts with state tax standards. In this mix, query whether standards like “necessary for the production” will look to general federal income tax principles or to state tax standards (e.g., the manufacturing rules for sales tax purposes). This item is also one of several that illustrate well the difference between the deductions available to sellers of goods and sellers of services. For example, a seller of desks may deduct depreciation for a computer that is associated with and necessary for the production of the desks. However, a seller of design services may not deduct depreciation for a computer that is associated with and necessary for the production of desk designs.

156. § 171.1012(c)( 7).

157. § 171.1012(c)( 8).

158. § 171.1012(c)( 9). This deduction applies to research and development expenditures “directly related to the production of goods” and raises more questions about the meaning of “directly.” *Id.*

159. § 171.1012(c)( 10).

160. § 171.1012(c)( 11).

161. TEX. TAX CODE ANN. § 171.1012(c)( 12) (Vernon Supp. 2006).

162. § 171.1012(c)( 13).

163. § 171.1012(c).

164. § 171.1012(d).

drafted the list differently. In any event, section 171.1012(d) includes the following:

- Deterioration of the goods;<sup>165</sup>
- Obsolescence of the goods;<sup>166</sup>
- Spoilage and abandonment, including rework labor, reclamation, and scrap costs;<sup>167</sup>
- Certain direct pre-production costs;<sup>168</sup>
- Certain direct post-production costs;<sup>169</sup>
- Certain insurance costs (plant, facility, machinery, equipment, or materials directly used in production);<sup>170</sup>
- Insurance on the produced goods;<sup>171</sup>
- Utilities, specifically including electricity, gas, and water directly used in production;<sup>172</sup>
- Quality control, including warranty replacement of defective components, inspection directly allocable to production, and repair and maintenance of the goods;<sup>173</sup>
- Licensing or franchise costs, including fees incurred in securing contractual rights to use trademarks, manufacturing procedure, or other listed rights directly associated with the goods;<sup>174</sup>
- Interest expense of a lending institution that offers loans to the public (according to a separate “notwithstanding-anything-else” type provision), such a lending institution may elect to deduct COGS and treat its interest expenses as COGS;<sup>175</sup> and
- Certain “indirect or administrative, or overhead costs.”<sup>176</sup>

The section regarding indirect, administrative or overhead costs allows deductions for these costs, including mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, or financial planning and management costs, if “allocable” to the acquisition or production of goods, but the deduction is capped at four percent of “total indirect or administrative overhead costs” and excludes any costs that are specifically excluded from the definition of COGS.<sup>177</sup>

Legislators not only listed items that *are* COGS but also listed items that are specifically excluded from COGS.<sup>178</sup> Specifically, the statute

---

165. § 171.1012(d)( 1).

166. TEX. TAX CODE ANN. § 171.1012(d)( 2) (Vernon Supp. 2006).

167. § 171.1012(d)( 3).

168. § 171.1012(d)( 4).

169. § 171.1012(d)( 5).

170. § 171.1012(d)( 6).

171. TEX. TAX CODE ANN. § 171.1012(d)( 7) (Vernon Supp. 2006).

172. § 171.1012(d)( 8).

173. § 171.1012(d)( 9).

174. § 171.1012(d)( 10).

175. § 171.1012(k).

176. § 171.1012(f).

177. *Id.*

178. *See* § 171.1012(e).

provides that following costs are excluded from COGS:

- Costs of renting or leasing equipment, facilities, or real property not used for production;<sup>179</sup>
- Selling costs, including employee expenses related to sales;<sup>180</sup>
- Distribution costs, including outbound transportation;<sup>181</sup>
- Advertising;<sup>182</sup>
- Idle facility expense;<sup>183</sup>
- Rehandling costs;<sup>184</sup>
- Bidding costs, regardless of whether the bid leads to a contract;<sup>185</sup>
- Interest expense, other than for certain financial institutions;<sup>186</sup>
- Income taxes, including local, state, federal, and foreign income taxes and income-based franchise taxes;<sup>187</sup>
- Strike expenses;<sup>188</sup>
- Officers' compensation;<sup>189</sup> and
- Compensation for undocumented workers used for the production of goods.<sup>190</sup>

The new legislation indicates that, except for real property contractors and federal government contractors who pass title to goods to the government before production is complete, an entity is generally allowed a cost-of-goods-sold deduction only for costs incurred with respect<sup>191</sup> to goods that it owns.<sup>192</sup> Motor vehicle lessors and renters, heavy equipment leasing companies, and railroad rolling stock rental or leasing companies are specifically authorized to use a cost-of-goods-sold deduction for items that they rent or lease,<sup>193</sup> although it is unclear how strictly this provision will be interpreted.

---

179. § 171.1012(e)( 1).

180. § 171.1012(e)( 2).

181. § 171.1012(e)( 3).

182. TEX. TAX CODE ANN. § 171.1012(e)( 4) (Vernon Supp. 2006).

183. § 171.1012(e)( 5).

184. § 171.1012(e)( 6).

185. § 171.1012(e)( 7), (8).

186. § 171.1012(e)( 9).

187. TEX. TAX CODE ANN. § 171.1012(e)( 10) (Vernon Supp. 2006).

188. TEX. TAX CODE ANN. § 171.1012(e)( 11) (Vernon Supp. 2006).

189. § 171.1012(e)( 12). The margin tax does not distinguish, as the current franchise tax does, between officers for industries which designate many persons as officers and officers for other industries. See TEX. TAX CODE ANN. § 171.110(a)( 1) (Vernon Supp. 2006) (as in effect until Jan. 1, 2008).

190. § 171.1012(e)( 14). For this purpose, "goods" specifically includes but is not limited to animal husbandry, crop growing and harvesting, and timber severance. § 171.1012(e)( 14)( B). The cost of benefits to such workers may, however, be deductible as COGS. Against the backdrop of the national debate on immigration law, this provision is not particularly surprising.

191. See § 171.1012(i). This provides that a taxable entity furnishing labor or materials to certain construction, improvements, remodeling, and industrial maintenance projects is considered an owner, and provides special rules for contracts with the federal government.

192. *Id.*

193. TEX. TAX CODE ANN. § 171.1012(k-1) (Vernon Supp. 2006).

The Tax Code defines "goods" for COGS purposes as "real or tangible personal property sold in the ordinary course of business of a taxable entity."<sup>194</sup> The term "sold" arguably suggests that renters or lessors generally cannot claim a COGS deduction; this interpretation is reinforced by the special margin tax rule which authorizes certain specific types of lessors and renters to take a COGS deduction, as well as by a proposed amendment that died in committee which would have clarified that "goods" for COGS purposes includes "real or tangible personal property sold or rented in the ordinary course of business of a taxable entity." However, in other tax contexts, particularly sales tax, Texas law often treats leases and rentals as sales,<sup>195</sup> so debate will continue.

In determining COGS, payments to an affiliate not part of a taxable entity's combined group are deductible only if the transaction is "at arm's length."<sup>196</sup> Although Texas has no COGS provision equivalent to Section 482 of the Internal Revenue Code,<sup>197</sup> this provision requires an analysis (without much guidance) of what constitutes arm's length.<sup>198</sup> The Comptroller could argue that this provision disallows any deduction, rather than disallowing a deduction only for the portion of the payment in excess of arm's length, but such an interpretation appears unduly harsh and inconsistent with prior sessions' legislative discussions and likely with this legislature's interest.

### *The Compensation Deduction*

Deductible compensation includes the following items:

- "Wages and cash compensation" paid to officers, directors, owners, partners, and employees,<sup>199</sup> capped at \$300,000 per person per year (indexed for inflation).<sup>200</sup>

The Comptroller's Guidelines provide that "net distributive income for the calculation of compensation is the amount of guaranteed payments

---

194. § 171.1012(a)(1).

195. See, e.g., TEX. TAX CODE ANN. § 151.005(2) (Vernon 2002) (including "lease, or rental of tangible personal property" in the definition of a sale).

196. TEX. TAX CODE ANN. § 171.1012(l) (Vernon Supp. 2006).

197. I.R.C. § 482 (2002) (regarding allocation of income among certain entities under common ownership or control).

198. TEX. TAX CODE ANN. § 171.1012(l) (Vernon Supp. 2006).

199. TEX. TAX CODE ANN. § 171.1013(b)(1) (Vernon Supp. 2006).

200. § 171.1013(c). Treatment of payments made to independent contractors continues to trigger substantial discussion, as well as suggestions for amending the statute to encompass such payments specifically. The cost of "all benefits" provided to officers, directors, owners, partners, and employees is not included in the \$300,000 per person deduction cap. "All benefits" is not statutorily defined, other than by providing that the term includes workers' compensation benefits, health care, contributions to employee health savings accounts, and deductible contributions to retirement plans. Because the \$300,000 cap applies to wages and not benefits, there would be an incentive, if Texas taxes were the only consideration, to shift compensation for highly compensated employees from wages to benefits. This incentive will be constrained to some extent by federal law, by the impact of such a shift on other states' taxes, and by restrictions on certain "top-heavy" benefit plans, though nonqualified plans may have more flexibility. Moreover, the relatively low tax rate may not provide sufficient savings to merit such shifts.

and distributions *made* during the accounting period . . . to natural persons from limited liability companies and corporations treated as S corporations for federal income tax purposes.”<sup>201</sup> However, calculating deductions by reference to amounts actually paid during the tax period would create a mismatch between the revenue and the expenses related to that income that seems inconsistent with the margin tax language and with sound policy.

In addition to the items listed above, the Tax Code provides that deductible “wages and cash compensation” also consists of the following:<sup>202</sup>

- Wages and tips reported on Form W-2 for medicare tax purposes;<sup>203</sup>
- Net distributive income to natural persons from partnerships and from trusts and LLCs treated as partnerships for federal income tax purposes, net distributive income to natural persons from LLCs, and corporations treated as S Corporations for federal tax purposes;<sup>204</sup>
- Stock awards and stock options deducted for federal income tax purposes;<sup>205</sup> and
- Special rules affecting “wages and cash compensation.”

No deduction is allowed for “wages and cash compensation” paid to undocumented workers, but a deduction is allowed for the cost of “all benefits” provided to undocumented workers.<sup>206</sup> Special provisions direct that compensation paid to persons employed by staff-leasing companies or management companies is deductible by the client company, not the staff-leasing or management company.<sup>207</sup> Generally, the thrust of the staff-leasing and management company provisions, sprinkled throughout the margin tax, is to treat workers assigned to an operating business as if

---

201. *Texas Franchise Tax Information Report—General Instructions*, [http://www.window.state.tx.us/taxinfo/franchise/05-158\\_instructions/index.html](http://www.window.state.tx.us/taxinfo/franchise/05-158_instructions/index.html) (follow “Texas Franchise Tax Information Report (05-158): General Instructions” hyperlink) (emphasis added).

202. § 171.1013(a).

203. *Id.* W-2 wages do not include the employer’s share of federal employment taxes. Payments to independent contractors reported on Form 1099 rather than W-2 raise additional issues. If no deduction is allowed for these Form 1099 payments, industries or businesses that use independent contractors for a significant part of their workforce may be materially disadvantaged, particularly if they are not able to take a COGS deduction or to exclude commission payments from revenue. Legislators may not have intended this result, and both they and the Comptroller appear to be considering carefully how to treat Form 1099 amounts.

204. *Id.* The treatment as compensation of net distributive shares of natural persons does not require that such “compensation” be related to labor performed by the recipient; thus, a pass-through entity is allowed a deduction with respect to the distributive share of net income of any individual investor. This deduction for net distribution income may be intended to guard against assertions that the margin tax violates the “Bullock amendment” to the Texas Constitution which requires voter approval of a tax on the income of natural persons, “including a person’s share of partnership and unincorporated association income.” However, since the deduction is capped at \$300,000, some will undoubtedly argue that the margin tax still reaches individuals’ shares of partnership net income. The Bullock amendment is article viii, section 24 of the Texas Constitution (named after a legendary former Texas comptroller).

205. TEX. TAX CODE ANN. § 171.1013(a)(3) (Vernon Supp. 2006).

206. §§ 171.1013(b)(2), (c-1).

207. §§ 171.1013(d)-(f).

they were employed by that business for purposes of computing revenue and related deductions.

### *Combined Reporting Principles*

Texas has never required or permitted any form of consolidated or combined reporting. Indeed, the stringent separate entity concept underlying the Texas franchise tax since its inception has allowed significant planning opportunities for taxpayers in affiliated groups by allowing the members to shift income and expenses among group members. The planning opportunities have been even greater since the federal check-the-box-rules because taxpayers could often shift income and expenses to out-of-state, disregarded LLCs. Those days of separate-entity simplicity are gone under the margin tax because all taxable entities that are part of an "affiliated group" engaged in a "unitary business" must report on a combined basis.<sup>208</sup>

### *The Affiliated Group*

For this purpose, "affiliated group" is defined as all entities in which a "controlling" eighty percent or greater interest is owned by a common owner or owners, or by one or more other members of the affiliated group.<sup>209</sup> The eighty-percent test for a corporation applies to "direct or indirect" ownership of total combined voting power of all classes of stock or the "beneficial ownership interest in the voting stock."<sup>210</sup> The eighty-percent test for other entities applies to direct or indirect ownership of "the capital, profits, or beneficial interest" in the entity.<sup>211</sup> In both cases, the meaning of "indirect" is open to debate. Significantly, the Texas affiliated group definition is freestanding; it does not directly incorporate or refer to any federal tax affiliated group classification or status.

Unfortunately, several aspects of the affiliated group definition remain unclear. The eighty-percent test applies to voting or beneficial interests<sup>212</sup>—but what if the same stock has different owners of voting rights and beneficial interests? Also, the definition applies to eighty-percent ownership "by a common owner or owners, either corporate or noncorporate."<sup>213</sup> This phrasing suggests that overlapping ownership of entities by natural persons could cause them to report on a combined basis, an unusual result. Moreover, the common-ownership test does not discriminate based on relative ownership shares by the common owners. It suggests, for example, that a partnership owned ninety-nine percent by person A and one percent by unrelated person B is part of an affiliated group with a partnership owned one percent by person A and ninety-nine

---

208. TEX. TAX CODE ANN. § 171.1014(a) (Vernon Supp. 2006).

209. TEX. TAX CODE ANN. § 171.0001(1), (8) (Vernon Supp. 2006) (though legislators plan to consider changing the eighty percent standard).

210. § 171.0001(8)(A).

211. § 171.0001(8)(B).

212. § 171.0001(8).

213. § 171.0001(1).

percent by person B. Finally, the sheer potential breadth of the definition creates a concern that seemingly independent entities could be traced through to eighty-percent common ownership—but what if several publicly held companies have eighty-percent common ownership? The impact of this broad “affiliated group” definition is somewhat limited because a combined reporting group includes only entities that are both members of an affiliated group *and* engaged in a “unitary business.”<sup>214</sup>

A combined group excludes foreign affiliates meeting certain property and payroll tests (or a gross receipts test if the affiliate has no payroll or property) which establish that eighty percent of their operations are outside the United States (“water’s edge reporting”).<sup>215</sup> The tests for determining the location of a foreign affiliate’s payroll and property are imported from the Multistate Tax Compact,<sup>216</sup> and are new concepts in Texas tax law.

While many states use a “unitary business” method of reporting state income tax, Texas historically has not (although in limited circumstances Texas has considered whether income from businesses is unitary).<sup>217</sup> Although the new Texas definition of unitary borrows from other definitions, it is—like the margin tax itself—different from other states. For margin tax purposes, “unitary business” means a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the Comptroller shall consider any relevant factor, including whether:

(A) the activities of the group members:

- (i) are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance; or
- (ii) are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; and

(B) The members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.<sup>218</sup>

---

214. TEX. TAX CODE ANN. § 171.0001(7) (Vernon Supp. 2006).

215. § 171.1014(a).

216. See TEX. TAX CODE ANN. § 141.001 (Vernon Supp. 2006) (Texas adoption of Multistate Compact).

217. See TEX. TAX CODE ANN. § 171.1061 (Vernon 2002) (allocation of certain taxable earned surplus to Texas).

218. TEX. TAX CODE ANN. § 171.0001(17) (Vernon Supp. 2006).



A single affiliated group can include multiple combined groups or entities that report on a separate entity basis, depending on which groupings of entities are "unitary."

As for the mechanics of combined group reporting: each member must first compute "total revenue" on a separate entity basis;<sup>219</sup> then, the members' separately computed revenues are added together,<sup>220</sup> and any intra-group revenues are subtracted.<sup>221</sup> All combined group members must make a uniform election to deduct either COGS or compensation,<sup>222</sup> and the combined group's COGS or compensation deduction is computed by determining deductible amounts (COGS or compensation) on a separate entity basis,<sup>223</sup> adding together the separately computed amounts,<sup>224</sup> and subtracting any intra-group payments.<sup>225</sup> The difference between the combined group's revenues and the combined group's deduction is the group's margin,<sup>226</sup> which is apportioned to Texas on a combined basis.<sup>227</sup>

As noted earlier in this article, the requirement that all members of a combined reporting group be bound by a uniform election to use a COGS or a compensation deduction may be quite harmful to members of combined groups that include members with divergent operations.<sup>228</sup> The COGS-versus-compensation decision will virtually always be based on which approach yields the lowest tax for the combined group; however, that choice may result in individual members' receiving minimal offsets against their revenue. For example, if a group includes both a manufacturing entity and a service provider, the group's taxes may be lower overall if it elects COGS, even though the service entity is not entitled to a COGS deduction and its entire total revenues will be included in gross margin. Moreover, if the seventy-percent cap on total revenues<sup>229</sup> applies at the combined group level, as is generally assumed, the cap would not limit to seventy percent the includible revenues of a member forced to use a disadvantageous deduction method.

In two different places the margin tax statute specifies that a "combined group" is deemed a single "taxable entity" for purposes of applying the tax.<sup>230</sup> In addition to creating confusion, this dual use of the term "taxable entity" suggests that the combined group as a whole is subject to either the default one-percent tax rate or the reduced half-percent tax

---

219. TEX. TAX CODE ANN. § 171.1014(c)(1) (Vernon Supp. 2006).

220. § 171.1014(c)(2).

221. § 171.1014(c)(3).

222. § 171.1014(d).

223. § 171.1014(e)(1).

224. TEX. TAX CODE ANN. § 171.1014(e)(2) (Vernon Supp. 2006).

225. § 171.1014(e)(3).

226. TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon Supp. 2006).

227. TEX. TAX CODE ANN. § 171.106(a) (Vernon Supp. 2006).

228. See § 171.1014(d).

229. § 171.101(a)(1)(A).

230. TEX. TAX CODE ANN. § 171.0002 (Vernon Supp. 2006) (defining the term "taxable entity"); TEX. TAX CODE ANN. § 171.1014 (Vernon Supp. 2006) (combined reporting).

rate for manufacturers and wholesalers, depending on whether the group's combined revenues meet the objective tests to qualify for the lower rate. By contrast, the mechanics for computing a combined group's taxable margin require that each member's "total revenue" and its deductible COGS or compensation must be computed "as if each member were an individual taxable entity."<sup>231</sup> Thus, at least some significant aspects of the margin tax computation are on a member-level rather than group-level basis.

A combined group may elect to include and treat as taxable an exempt entity that is otherwise part of its affiliated, unitary group.<sup>232</sup> Such an election could allow an exempt entity with high non-Texas gross receipts and a low gross margin to reduce the combined group's taxable margin.

Another margin tax provision is intended to allow an upper-tier entity (e.g., a partner) to elect to report and pay the tax on the taxable margin of a lower level pass-through entity in which it owns an interest (e.g., a partnership) but that is not part of its combined group; however, the terms "upper tier" and "lower tier" are reversed in the statute as a result of a drafting error.<sup>233</sup>

In an attempt to fill some gaps left by the statute, the Comptroller's Guidelines define "Reporting Entity" as "the principal Texas entity that is responsible for reporting on behalf of the combined group," and define "Principal Texas entity" as

an entity that is the parent entity unless the parent entity is not subject to tax in Texas; is not part of the unitary business; or there is no parent, in which case it means the entity that: (1) is included within the group; (2) is subject to Texas' taxing jurisdiction; and (3) has the greatest Texas business activity during the first year that a combined return is required to be filed, as measured by the total revenue for that year.<sup>234</sup>

### *Apportionment Concepts*

The new tax imports most of the old tax's concepts for apportioning the tax base. Thus, the margin tax allocation relies on a single-factor approach that multiplies the tax base by the ratio of an entity's or group's Texas gross receipts to total gross receipts.<sup>235</sup> In a holdover from the earned surplus component of the pre-margin franchise tax, "gross receipts" are generally to be determined under federal tax gross income principles.<sup>236</sup> The principles for determining whether a particular gross

---

231. § 171.1014(f)(1).

232. § 171.1014(g).

233. TEX. TAX CODE ANN. § 171.1015 (Vernon Supp. 2006).

234. *Texas Franchise Tax Information Report—Combinations and Eliminations Schedule*, [http://www.window.state.tx.us/taxinfo/franchise/05-158\\_instructions/index.html](http://www.window.state.tx.us/taxinfo/franchise/05-158_instructions/index.html) (follow "Texas Franchise Tax Information Report—Combinations and Eliminations Schedule (05-161): Instructions" hyperlink).

235. TEX. TAX CODE ANN. § 171.106(a) (Vernon Supp. 2006).

236. TEX. TAX CODE ANN. § 171.104 (Vernon Supp. 2006).

receipt is a "Texas gross receipt" are largely unchanged from the old franchise tax, although there are two significant changes.<sup>237</sup> First, while services generally continue to be sourced to Texas only if "performed in this state,"<sup>238</sup> receipts from servicing loans secured by real property are now sourced to Texas if the real property is located in Texas.<sup>239</sup> Second, Texas has eliminated its long-standing "throwback rule," which sourced to Texas any receipts from sales of tangible property shipped from Texas into a state in which the seller has insufficient contact to be subject to state income tax.<sup>240</sup>

For groups reporting on a combined basis, Texas has adopted the *Joyce* rule to apportion the gross margin of combined groups that contain members which lack tax nexus with Texas.<sup>241</sup> Under this rule, gross receipts from any group members that do not have stand-alone tax nexus with Texas are not treated as Texas gross receipts for apportionment purposes;<sup>242</sup> however, such "no-nexus" group members' gross receipts are included in total gross receipts.<sup>243</sup> In other words, gross receipts from no-nexus entities will be included in the denominator but not the numerator of the group's apportionment factor.

"Gross receipts" for apportionment purposes are defined to include "all revenues reportable by a taxable entity on its federal tax return, without deduction . . . unless otherwise specifically provided," though any receipts excluded from total revenues are also excluded from gross receipts.<sup>244</sup> For combined groups, any intra-group revenues that are excluded from the computation of the combined group's total revenue are generally excluded from receipts for apportionment purposes.<sup>245</sup> To prevent tax-avoidance structures, however, the legislation provides that if a non-nexus member of a combined group sells into Texas, without modification, any tangible property purchased from a member that has nexus, then the non-nexus member's revenues are treated as Texas gross receipts.<sup>246</sup>

"Gross receipts" for apportionment purposes are defined differently than "total revenues,"<sup>247</sup> and it is possible that this difference may cause some amounts to be included in one but not the other. Although this possibility is reduced by excluding from gross receipts the amounts ex-

---

237. See TEX. TAX CODE ANN. § 171.103 (Vernon Supp. 2006).

238. § 171.103(2).

239. *Id.*

240. In *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856, 868 (Tex. App.—Austin 2005, pet. denied), the Austin Court of Appeals found that the throwback rule is unconstitutional, at least in some circumstances.

241. *In re Appeal of Joyce, Inc.*, No. 66-SBE-069, 1966 WL 6789 (Cal. St. Bd. Of Equal., Nov. 23, 1966); TEX. TAX CODE ANN. § 171.103(b) (Vernon Supp. 2006).

242. § 171.103(b).

243. TEX. TAX CODE ANN. § 171.105(c) (Vernon Supp. 2006).

244. TEX. TAX CODE ANN. § 171.1121(a) (Vernon Supp. 2006).

245. TEX. TAX CODE ANN. § 171.1055 (b) (Vernon Supp. 2006).

246. *Id.*

247. Compare TEX. TAX CODE ANN. § 171.105 (Vernon Supp. 2006) (gross receipts), with TEX. TAX CODE ANN. § 171.1011(c) (Vernon Supp. 2006) (total revenue).

cluded from revenues, there may be instances in which amounts included in the definition of total revenues differ from amounts included in the definition of gross receipts. However, some Comptroller representatives have indicated their belief that gross receipts should equal gross revenues.

### *Tax Rates*

The default rate is one percent of taxable margin,<sup>248</sup> but the rate is reduced to one-half percent<sup>249</sup> if more than fifty percent<sup>250</sup> of a taxable entity's total revenues are from "retail trade" or "wholesale trade"<sup>251</sup> as defined by the referenced Standard Industrial Classification ("SIC") Codes<sup>252</sup> (but excluding sellers of telecommunications or utilities), and (other than for bars and restaurants) less than fifty percent of such retail/wholesale revenues derives from products that a taxable entity or its affiliate produces.<sup>253</sup> These tests are based on 1987 SIC classifications which include bars and restaurants, rather than the more recent classifications. The lower, one-half percent rate is not available to a taxable entity that "provide[s] retail or wholesale utilities, including telecommunications services and electricity or gas."<sup>254</sup> This limitation creates another "cliff," with perhaps unintended consequences: is a retailer that leases its excess telecommunications circuit capacity to a third party ineligible for the lower percent rate?<sup>255</sup>

### *Credits*

Only limited credits are available against the margin tax, and they relate to previously accrued items. A taxpayer with certain losses from prior years may use a portion of that loss as a credit, but confusing statutory language has hampered taxpayers' (and the Comptroller's) ability to compute the credit. By its terms, the temporary credit, which is intended to be spread out over a ten-year period, is calculated by multiplying the taxpayer's apportioned net operating losses and certain temporary accounting differences by the tax rate and then multiplying that product by ten percent.<sup>256</sup> However, legislative discussions focused on "business losses" accrued under the old franchise tax, and legislation will likely be necessary to clarify the credit. The tax rate cited in this loss-credit provi-

---

248. TEX. TAX CODE ANN. § 171.002(a) (Vernon Supp. 2002).

249. § 171.002(b).

250. § 171.002(c)( 2).

251. § 171.002(c).

252. TEX. TAX CODE ANN. § 171.0001(12), (18) (Vernon Supp. 2006).

253. TEX. TAX CODE ANN. §§ 171.002(b), (c), (c)( 1) (Vernon Supp. 2006).

254. § 171.002(c)( 3).

255. The Texas Tax Section Comments propose that this section be amended to make explicit that the resale of excess telecommunications capacity should not be considered retail or wholesale [utilities] trade. Letter from Texas Tax Section to Frank Battle, Senior Counsel for Public Policy, State of Texas (Jan. 23, 2007) available at [http://www.texasastaxsection.org/sectionoftaxationlettertoFrankBattle\\_HB3.pdf](http://www.texasastaxsection.org/sectionoftaxationlettertoFrankBattle_HB3.pdf).

256. TEX. TAX CODE ANN. § 171.111(b) (Vernon Supp. 2006).

sion is to the four-and-one-half percent rate appearing in the old franchise tax provisions (i.e., the rate against which accrued Texas franchise tax business losses would have been credited under pre-margin tax law).<sup>257</sup> However, House Bill No. 3 repeals that section, and the Comptroller's office has indicated, including in the directions in the on-line franchise tax calculator,<sup>258</sup> that the new margin tax rates should apply, so legislators may also address the tax rate.

Although the credit provision refers to March 1, 2007, as the date by which a taxable entity is to notify the Comptroller of the taxpayer's intent to claim this credit,<sup>259</sup> that date is unreasonably early, particularly in view of the many unanswered questions with respect to the credit. The Comptroller has adopted a rule that would instead require notice on or before September 1, 2007.<sup>260</sup>

Other credits that taxpayers are allowed to carry forward from the old franchise tax to the new margin tax are the strategic investment area credit,<sup>261</sup> the research and development credit,<sup>262</sup> the job creation credit,<sup>263</sup> and the capital investment credit.<sup>264</sup>

### *Effective Date and Transition Issues*

The various transition rules are reasonably clear as applied to individual entities, but there is some ambiguity in applying these rules to a combined group, particularly if the combined group contains some members subject to the existing franchise tax and other members who will be newly subject to the margin tax. Statutory references to the period on which the tax is based further complicate determining when and on what basis returns must be filed. Although the Comptroller is working to provide informal or regulatory guidance on these issues, legislators may also enact technical corrections to address several of these issues.<sup>265</sup>

As noted earlier, the margin tax will be effective for reports due on or after January 1, 2008, but those reports will include revenues from earlier periods.<sup>266</sup> For example, a calendar year taxpayer will file a report May 15, 2008, which will include a margin tax computed with respect to all revenues earned during calendar year 2007. For fiscal year taxpayers, the

---

257. § 171.111(b)(4).

258. *Franchise Tax Calculator*, <http://www.window.state.tx.us/taxinfo/franchise/calculator/> (follow "Download the Franchise Tax Calculator (PDF)." hyperlink).

259. § 171.111(a).

260. 34 TEX. ADMIN. CODE § 3.594 (2007) (Tex. Comptroller of Pub. Accounts, Margin: Temp. Credit).

261. TEX. TAX CODE ANN. §§ 171.722-723 (Vernon Supp. 2006).

262. *Id.*

263. TEX. TAX CODE ANN. §§ 171.752-753 (Vernon Supp. 2006).

264. TEX. TAX CODE ANN. §§ 171.802-803 (Vernon Supp. 2006).

265. As a planning and revenue-projection tool for the state, certain large taxpayers are required to file information reports by February 15, 2007, to report the margin tax they would have paid based on 2005 activity had the margin tax been in effect for that year. It is widely expected that legislators may delay enacting margin tax amendments until these returns have been filed.

266. Tex. H.B. 3 § 22(a), 79th Leg., 3d C.S. (2006).

margin tax computations cannot apply to business activity before June 1, 2006.<sup>267</sup> Transition provisions specify the accounting periods on which the tax is based for the first reports filed by entities made newly subject to tax by the margin tax (e.g., partnerships).<sup>268</sup> Anti-tax avoidance provisions are designed to treat successor partnerships as “continuations” of predecessor partnerships for purposes of computing the initial report under the margin tax.<sup>269</sup>

The Guidelines address a question not answered by the statute, by providing that if the taxable year of a member differs from the taxable year of the group, the principal Texas entity may elect to determine the portion of that member’s revenue and cost of goods sold or compensation amounts to be included in the report in one of the following ways: a separate income statement prepared from the books and records for the months included in the group’s taxable year; or including all of the income for the year that ends during the group’s taxable year.<sup>270</sup>

The Guidelines further state that the “same method must be used for each member with a different accounting period.”<sup>271</sup>

The margin tax legislation explicitly and repeatedly delegates to the Comptroller the authority to enact administrative rules interpreting or implementing many facets of the new tax system. The Comptroller’s online “Franchise Tax Calculator” and a few letter rulings offer some insight to taxpayers. However, the massive changes enacted to the franchise tax system will undoubtedly produce not only confusion and controversy, but also judicial and legislative attention. The Texas Legislature’s 2007 regular session began in January and should yield at least some technical corrections. Although taxpayers will ask legislators to consider major revisions, legislators are unlikely to overhaul the margin tax.

### III. PROPERTY TAX

#### A. LEGISLATION

The Texas Legislature’s lowering of school property taxes was the most significant 2006 Texas property tax development. School property taxes are comprised of essentially two different tax rates—the maintenance tax rate (the “M&O Rate”) for regular operating expenses,<sup>272</sup> and the interest and sinking fund rate for servicing debt.<sup>273</sup> Pursuant to new section 42.2516 of the Texas Education Code, sufficient state funds will be provided to each school district to enable it to reduce its M&O property tax

---

267. Tex. H.B. 3 § 22(b).

268. *Id.*

269. Tex. H.B. 3 § 22(f).

270. *Texas Franchise Tax Information Report—Combination and Eliminations Schedule*, [http://www.window.state.tx.us/taxinfo/franchise/05-158\\_instructions/index.html](http://www.window.state.tx.us/taxinfo/franchise/05-158_instructions/index.html) (follow “Texas Franchise Tax Information Report—Combinations and Eliminations Schedule (05-161): Instructions” hyperlink).

271. *Id.*

272. TEX. EDUC. CODE ANN. §§ 45.002, .003 (Vernon Supp. 2006).

273. § 45.003(b).

rate by 12.67 percent in 2007 and by 33.33 percent in 2008 and later years, in each case as compared to its 2005 M&O property tax rate.<sup>274</sup> Thus, if a school district taxes at the maximum M&O property tax rate (\$1.50 per \$100 valuation) in 2005, its M&O rate will ultimately be lowered to \$1.00 per \$100 valuation. The Texas Legislature established a property tax relief fund to be used to make payments to school districts to enable them to lower their M&O rate as required by law.<sup>275</sup> The property tax relief fund, which is a special fund outside the general revenue fund, accumulates a specified percentage of the new Texas franchise tax, the increase in the cigarette tax and the amended motor vehicle sales tax.<sup>276</sup>

#### B. JUDICIAL DECISIONS AND ATTORNEY GENERAL OPINION

Several of the cases during the 2006 Survey period demonstrate that the consequences of failure to follow statutory procedural requirements can be dire, for taxpayer and appraisal districts alike. A perfect example is *Jim Wells County v. El Paso Production Oil and Gas Co.*, in which the Houston Court of Appeals for the First District held that a tax unit, common-law suit against several oil companies alleging fraud to achieve lower property taxes must be dismissed because the tax units failed to utilize required administrative remedies.<sup>277</sup> In *Jim Wells*, numerous counties and school districts sued in state district courts for fraud and similar actions against multiple energy companies, alleging that the energy companies conspired to defraud the taxing units by manipulating oil and gas markets in order to undervalue property for property tax purposes.<sup>278</sup> The tax units filed suit without having raised this issue with an appraisal review board under the procedures prescribed in the Tax Code.<sup>279</sup>

The energy companies asserted that the lawsuits should be dismissed for failure of the tax units to exhaust their administrative remedies. The tax units asserted that their fraud claims are common law claims not governed by the Tax Code. The court of appeals rejected the tax units' arguments and upheld the lower courts' dismissal of the lawsuits.<sup>280</sup> The court of appeals concluded that the tax units should have raised the issue under section 25.21 of the Tax Code, which allows the appraisal district to tax property omitted from the tax rolls in prior years.<sup>281</sup> The tax units asserted that section 25.21 does not apply to undervalued property, and thus its only remedy would be under common law. However, the court of appeals concluded that section 25.21 does apply to property undervalued

---

274. TEX. EDUC. CODE ANN. §§ 42.2516(a), (a-1) (Vernon Supp. 2006).

275. TEX. GOV'T CODE ANN. § 403.109 (Vernon Supp. 2006).

276. TEX. TAX CODE ANN. §§ 171.4011, 152.1222, 154.6035 (Vernon Supp. 2006).

277. 189 S.W. 3d 861, 872 (Tex. App.—Houston [1st Dist.] 2006, pet. denied).

278. *Id.* at 866-67. Specifically, the tax units alleged that the energy companies intentionally sold energy to affiliates for lower prices, who later sold for higher prices to unrelated third parties, and based appraisals on these lower sales prices.

279. *Id.*

280. *Id.* at 872.

281. TEX. TAX CODE ANN. § 25.21 (Vernon 2002).

due to fraud.<sup>282</sup>

Similarly, in *Houston I.S.D. v. 1615 Corp.*, the application of the exclusive remedies provisions of the Tax Code was the death knell of a taxpayer's property tax claim.<sup>283</sup> This case concerns a taxpayer suit to avoid a foreclosure sale of its property for delinquent property taxes. The taxpayer had acquired the property after the resolution of a tax suit that resulted in the assessment of delinquent property taxes on the property.<sup>284</sup> The taxpayer asserted in its lawsuit that property taxes were substantially overstated because of a mistake by the tax units in removing a homestead exemption. However, the taxpayer filed the lawsuit (seeking an equitable bill of review, among other remedies) without having complied with the administrative remedies set forth in the Tax Code. The Houston Court of Appeals for the Fourteenth District previously held that the failure to exhaust administrative remedies was not grounds for dismissing the lawsuit,<sup>285</sup> but changed its opinion following the Texas Supreme Court's holding in *Cameron Appraisal District v. Rourk*, where the supreme court stated that the supreme court has "repeatedly held that a taxpayer failure to pursue an appraisal review board proceeding deprives the courts of jurisdiction to decide most matters relating to [property] taxes."<sup>286</sup>

In *Letter Opinion GA-0485*, the Attorney General addressed whether property owned by a limited partnership formed by a government entity as a general partner and a nonprofit entity as a limited partner can be exempt from property taxes as public property.<sup>287</sup> Under section 11.11 of the Tax Code, property owned by the state or a political subdivision is exempt if the property is used for public purposes.<sup>288</sup> The Attorney General stated that the issue must be considered on a case-by-case basis, but set forth two ground rules for addressing the issue.<sup>289</sup> First, under partnership statutes, a limited partnership's property belongs to the limited partnership and not to its partners; thus, as a partner of the limited partnership, the government entity does not own the property.<sup>290</sup> Second, there can be circumstances in which a government entity does not own legal title to property but owns such property through equitable title (and thus could take advantage of the exemption under section 11.11).<sup>291</sup> In order to own equitable title to property, the government entity must have

---

282. *Jim Wells*, 189 S.W.3d at 872.

283. 217 S.W.3d 631 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

284. *Id.* at 632.

285. *Id.* at 634 (citing *Houston I.S.D. v. 1615 Corp.*, No. 14-04-00859-CV, 2005 WL 2787279, at \*4-6 (Tex. App.—Houston [14th Dist.] Oct. 27, 2005, no pet. h.) (withdrawn)).

286. 194 S.W.3d 501, 502 (Tex. 2006). Presumably, the taxpayer's best claim would have been a clerical error under section 25.25(c)(3) of the Tax Code. See TEX. TAX CODE ANN. § 25.25(c)(1) (Vernon Supp. 2006).

287. Op. Tex. Att'y Gen. No. GA-0485 (2006).

288. TEX. TAX CODE ANN. § 11.11(a) (Vernon 2002).

289. Op. Tex. Att'y Gen. No. GA-0485 (2006).

290. *Id.*

291. *Id.*



the present right to compel legal title to itself.<sup>292</sup>

In *Patterson-UTI Drilling Co. v. Webb County Appraisal District*, the San Antonio Court of Appeals addressed the tax situs of mobile drilling rigs. Patterson Drilling owns hundreds of drilling rigs that it moves throughout Texas at its clients' requests.<sup>293</sup> Its principal place of business is in Scurry County, Texas.<sup>294</sup> The rigs move constantly, with each job taking as short as two weeks or as long as five months.<sup>295</sup> Until there is another job for a rig, it remains at its last job site.<sup>296</sup> On January 1, 2002, two of Patterson Drilling's rigs were in Webb County, had been there approximately six months, and had each been idle for over a month.<sup>297</sup> Patterson Drilling rendered these rigs in Scurry County, but Webb County also asserted taxes on these rigs, resulting in double taxation.<sup>298</sup> The trial court concluded that the rigs had been in Scurry County for more than a temporary period and held that they were taxable in Webb County for the 2002 tax year.<sup>299</sup>

Under section 21.02 of the Tax Code, tangible personal property is taxable by a taxing unit if, among other ways for it to be taxable in such taxing unit, the property is located in the tax unit on January 1 of the tax year for more than a temporary period.<sup>300</sup> The Tax Code, however, does not define "temporary period." Thus, the court of appeals addressed this term as it applied to the two rigs. The court of appeals concluded that "temporary period" means "lasting for a limited time."<sup>301</sup> Because the rigs were constantly moving and remained in Webb County only until needed at another site, the court of appeals concluded that the rigs should not be taxed in Webb County.<sup>302</sup>

#### IV. PROCEDURE

In *El Paso Natural Gas Co. v. Strayhorn*, the Texarkana Court of Appeals addressed the interplay between the franchise tax and the statute of limitations.<sup>303</sup> While the case addresses franchise taxes, the more interesting analysis is its focus on procedural matters. El Paso Natural Gas Company ("El Paso") contested its franchise tax liability over a three-

---

292. *Id.*

293. 182 S.W.3d 14, 16 (Tex. App.—San Antonio 2005, no pet.).

294. *Id.*

295. *Id.*

296. *Id.*

297. *Patterson-UTI Drilling*, 182 S.W.3d at 16.

298. *Id.*

299. *Id.*

300. TEX. TAX CODE ANN. § 21.02(a) (Vernon 2002 & Supp. 2006).

301. *Patterson-UTI Drilling*, 182 S.W.3d at 18.

302. *Id.* at 19. Ultimately, the rigs stayed in Webb County until January 1, 2003, because Patterson Drilling secured the next contract for these rigs for use in Webb County. However, the court noted that such facts are irrelevant to the taxable situs issue because the situs issue is determined by looking back in time to the location of the property in the year preceding January 1, 2002. *Id.* at 18.

303. *El Paso Natural Gas Co. v. Strayhorn*, 208 S.W.3d 676, 678-81 (Tex. App.—Texarkana 2006, no pet. h.)

year period as a consequence of a series of events stemming from the Comptroller's change in policy regarding the accounting methods available to petroleum producers and manufacturers.<sup>304</sup> In February 1991, the Comptroller announced that petroleum producers and manufactures could use either the "full cost" or the "successful efforts" accounting method and allowed taxpayers to amend their 1988, 1989, and 1990 franchise tax returns "to reflect a change from the 'full cost' accounting method to the 'successful efforts' method."<sup>305</sup> To take advantage of this opportunity, taxpayers had to file the amended returns by February 28, 1991.<sup>306</sup> However, a "protective claim" letter filed by that same date and later supplemented with the amended returns at any time within the following six months would also satisfy the deadline.<sup>307</sup> The Comptroller's allowance of these retroactive accounting changes appeared to directly conflict with Rule 3.391, which expressly forbids retroactive accounting changes not designed to correct mathematical or accounting errors.<sup>308</sup>

El Paso mailed its protective claim letter by February 28, 1991, but the Comptroller never received the letter.<sup>309</sup> And the mere mailing was held insufficient to preserve El Paso's right to amend its returns.<sup>310</sup> Alternatively, El Paso argued that the Comptroller violated Rule 3.391 by setting the arbitrary February 28, 1991, deadline.<sup>311</sup> The court of appeals dismissed this argument by noting that the Comptroller had the power to suspend Rule 3.391 for a limited period of time.<sup>312</sup> The court of appeals reasoned that the creation of a temporary window allowing such retroactive accounting changes is within the Comptroller's authority because, "as Section 111.002(a) of the Texas Tax Code makes clear, the Comptroller has the statutory discretion to adopt reasonable rule changes that do not conflict with Texas law."<sup>313</sup> Thus, "because this was a rule change and not a statutory change, the Comptroller was authorized to limit the time frame for the rule change's applicability."<sup>314</sup>

## V. WHAT'S NEXT?

From the next legislative session, we will see substantive procedural changes, more new rules, and more court cases. In short, more changes to Texas taxes.

---

304. *See id.*

305. *Id.*

306. *Id.* at 679-80.

307. *Id.* at 680.

308. *Id.* at 680 n.5; *see* TEX. TAX CODE ANN. § 111.002(a) (Vernon 2002) ("comptroller may adopt, repeal, or amend such rules to reflect changes in power of this state to collect taxes and enforce the provisions of this title. . . .").

309. *El Paso*, 208 S.W.3d at 680.

310. *Id.*

311. *Id.* at 681.

312. *Id.* at 680 n.5.

313. *Id.*

314. *Id.*

